IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No.

AVIATION CAPITAL, INCORPORATED
(In Liquidation),

Petitioner,

against

WILLIAM J. PEDRICK, Collector of Internal Revenue,
Second District of New York.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

Opinions of the Courts Below

The opinion in the Circuit Court of Appeals for the Second Circuit (R. 116) has not yet been reported. The opinion of the District Court is reported in 56 F. Supp. 964.

Jurisdiction

Reference is made to the petition, p. 2, *supra.*

Statement of the Case

Reference is made to the "Statement" in the petition, pp. 4-6, *supra.*

Specification of Errors

The Court is respectfully referred to that part of the petition which sets forth the questions presented (pp.

2-3, *supra*) and to that part which sets forth the reasons for the allowance of the writ (pp. 6-7, *supra*).

Summary of the Argument

1. This is not an attempt to induce this Court to correct an appraisal of facts. The error below is only an error in fact to the extent that it marks the furthest stretch of a Treasury regulation which has received interpretation in several of the Circuits. The courts have accorded the regulation a breadth it cannot validly have, and hold implicitly that the tax law in this respect is whatever the Commissioner of Internal Revenue says it is. The transactions here were found by the District Court to have been to secure much needed capital. The repurchases were obligatory under the corporate charter and at the current liquidation value which precluded bargaining as to price. The corporation did not treat the treasury stock on its books as it treated other stock. Sales of treasury stock were at asset liquidation value. The sound accounting view, which ought to be given weight in the courts, is that there can be no profit here. The Securities and Exchange Commission adopts the sound accounting view. There is, therefore, a definite conflict between two important government agencies with respect to a basic practice.

2. Our view was that accepted by the Treasury by regulation for fifteen years. By reenactment of Section 22(a) of the Internal Revenue Code, Congress adopted that regulation. The present regulation is therefore invalid because its predecessor was so far imbedded in the law that it could be removed only by Congress.

3. The transactions involved being capital transactions, Section 22(a) of the Internal Revenue Code does not authorize a tax because that statute cannot be construed to cover capital transactions.

4. If Section 22(a) of the Internal Revenue Code must be interpreted to cover these transactions to raise capital,

it is unconstitutional because the Sixteenth Amendment authorizes a tax on income and not a tax on a portion of the capital raised by promoters.

ARGUMENT

POINT I

The decision of the Circuit Court of Appeals crystallizes a situation with respect to repurchase and resale of corporate stock which has received varying treatment in the Treasury, the Securities and Exchange Commission and the courts and which should now be straightened out.

This petition was not filed to induce this Court to correct an error in appraisal of facts. That happened, strikingly. But this Court has not the time merely to straighten out such mistakes.

The present case offers the opportunity to supply valuable guidance to taxpayers and the tax bar with respect to the broad question of a corporation's dealing in its own stock. The fact that in the cases of this type so far litigated in the Circuit Court of Appeals the taxpayer has always lost does not mean that no problem exists; it means that step by step a regulation of doubtful legitimacy has been judicially implemented to the point where, as here, the trial Court can characterize a transaction as one to raise capital (R. 95) and yet find that the corporation's transactions in its own stock had exactly the same aspect as if it were buying and selling cows.

The pious recital of the regulation that taxability "depends upon the real nature of the transaction" and that taxability depends upon whether a corporation "deals in its own shares as it might in the shares of another corpora-

tion" becomes irony when the trend of decision is as it is. This decision is that most pernicious thing, the giving of the form but not the substance of justice.

The District Court found that the petitioner sold its reacquired stock "in order to raise much needed working capital" (R. 95). The transaction was thus a capital transaction. Accordingly, by holding nevertheless that there was a tax due here the Courts have announced a paradox, *i. e.*, that the raising of capital by a corporation is a profit-making venture. The paradox is rendered perfect by the fact that, as found by the District Court, the resale price of the stock was at current liquidation value of the petitioner's assets (R. 95); so the "profit" lay in the enhancement of the value of the assets of the corporation unrealized by it!

This Court has not passed upon the fundamental proposition whether a corporation can profit from the sale of its own stock at liquidation value. Unless tax law is to have its own Pickwickian language, it is absurd to say that such profit can be derived. Our point has been perfectly stated by Judge LEARNED HAND in *E. R. Squibb & Sons* v. *Helvering*, 98 F. (2d) 69 (C. C. A. 2, 1938) (at pp. 70-71):

> "* * * Nevertheless it is very difficult—indeed to us it seems impossible—to understand how the notion of a gain to the corporation from such transactions is legally tenable, except when the sale of the shares is at a price higher than their real value at the time of the sale. Such a belief must depend upon the mistaken supposition that after purchase the shares have an existence as such, and are more than a mere power to issue shares, like authorized, but unissued, shares. This seems to us unsound. Borg *v.* International Silver Company, 2 Cir., 11 F. 2d 147.
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> "If one regards the corporation as the group of its shareholders collectively, that is very apparent. If they sell 'treasury shares', bought at a lower price, what really happens is that the group has been en-

larged; new shareholders have been added. Always assuming that the shares are sold at their true value, the old group has not profited because the sale of the 'treasury shares' leaves the value of their own shares absolutely untouched. The purchase price received for each 'treasury share' sold will by hypothesis exactly match the value of each old share, and the sold share will neither trench upon, nor leave any margin of profit for, the old shares. All that has happened is that a larger group is doing business with a proportionally increased capital. The same is true also, if the corporation be regarded as a juristic person, stricti juris. Before the sale of 'treasury shares' the corporation is liable to its shareholders in the sum of their claims against it, which equal the net value of its then assets, including any increase in their value during the period when the 'treasury shares' have been held. The corporate assets are of course increased by the sale, but the new shares create new liabilities which will precisely equal the increase, and there can be no profit to the corporation. The only escape from this is to treat the corporation as so completely independent of its shareholders, that its obligations to them should be disregarded in figuring its gains or losses. But to do that would completely distort the corporate income, and charge it as profit with all that it receives when it sells 'treasury shares', and to credit it as loss with all that it pays to purchase them. Indeed, the whole reasoning which supports the emergence of profit from such transactions presupposes that the corporation has relieved itself of an obligation when it buys a share and creates one when it sells one. Since on analysis this appears to be legally untenable, it is plain that the original interpretation of the Treasury was at least permissible. * * *"

It was this statement and Judge HAND's dissent in *Commissioner* v. *Air Reduction Co.*, 130 F. (2d) 145, 148 (C. C. A. 2, 1942), which caused concurring Judge FRANK to say below (R. 115) that:

> "The prevailing rule is a singular triumph of form over substance."

If this corporation had bought and retired its own stock and issued *theretofore unissued* stock when new investors desired to come in, all practical results would have been the same except that this tax would not have been imposed (Reg. 101, Art. 22-a-16). Merely for that reason, purely technical, the Commissioner has levied a tax.

The impropriety of including "income" from sale of treasury stock in the profits of a corporation—because against sound accounting practise and Securities and Exchange Commission standards—is fully demonstrated in *Winkelman et al.* v. *General Motors Corporation et al.*, 44 F. Supp. 960 (S. D. N. Y. 1942) at pp. 989 *et seq.* There it was held that such could *not* be included in the base for corporate officials' bonus, and the judicial narration of the recent history of this problem points with certainty to the answer in this case.

The SEC of course takes another view of the effect of transactions like those here involved. It has ruled (SEC Accounting Series, Release No. 6):

> "It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or earned surplus. There would seem to be no logical reason why surplus arising from the reacquisition of the company's stock and its subsequent resale should not also be treated as capital."

The SEC regulations are consistent with this ruling (see Reg. S-X, Art. 5, Rules 3.16 and 5.03).

Thus two important agencies of the government take diametrically opposite views of our situation.

POINT II

The regulation involved is invalid because Congress, by reenactment of the relevant statute, adopted the predecessor regulation and it continued in effect at the time when the taxes were levied.

Until 1932 the regulations said flatly that a corporation could not make a profit from transactions in its own stock.

Article 22(a)-16 (p. 3, *supra*), representing the challenged change in the regulation made in 1932, is the regulation applicable. In *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 114 (1939), the Commissioner tried to apply the new regulation to a transaction completed before its adoption. This was forbidden by this Court. But the question of the validity of the present regulation was explicity left open (at pp. 116-117):

> "* * * We need not now determine whether, as has been suggested,* the alteration of the existing rule, even for the future, requires a legislative declaration or may be shown by reënactment of the statutory provision unaltered after a change in the applicable regulation. As the petitioner points out, Congress has, in the Revenue Acts of 1936 and 1938, retained § 22(a) of the 1928 Act *in haec verba*. From this it is argued that Congress has approved the amended regulation. It may be that by the passage of the Revenue Act of 1936 the Treasury was authorized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reënactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928."

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* "*Squibb & Sons* v. *Helvering*, 98 F. 2d 69, 70."

The Commissioner has since 1913 taken many positions of the general problem, and they should be set out here.

Regulations 33, Art. 98 provided that if a corporation resold repurchased stock at a higher price the excess was income.

Regulations 45, Art. 542 and Regulations 62, Art. 543 reversed this position and stated that no gain or loss resulted from the purchase of a corporation's own stock.

Then Regulations 65 provided that no gain or loss resulted from the purchase or sale of a corporation's own stock. This was carried through Regulations 69, 74 and 77. Then in 1932, in *Commissioner* v. *S. A. Woods Machine Company*, 57 F. (2d) 635 (C. C. A. 1), cert. den. 287 U. S. 613, the Commissioner succeeded in stretching his own regulation to cover a "profit" from the receipt of a corporation's own stock in settlement of a claim. The regulations were instantly amended to incorporate directly some of the language of that decision. It is the successor regulation which we assert is invalid, because the predecessor regulation had become a part of the law of the land through reenactment of the statute. It became imbedded in the statute. If the law was to be changed adversely to taxpayers Congress and not the Commissioner should do it.

It is settled law that an administrative interpretation followed, as was the pre-1932 regulation here, by repeated reenactment of the relevant statute becomes the law because Congress has "adopted" it. *Morgan* v. *Commissioner*, 309 U. S. 78, 81 (1940); *Brewster* v. *Gage*, 280 U. S. 327, 337 (1930). For years transactions like those here involved were not taxable, under regulations ripened into law. What had in 1932 became law could not by administrative action be diametrically changed. The reenactment rule and good administration are mocked if a seasoned regulation can overnight be changed into its opposite.

POINT III

Section 22(a) does not support the regulation if the regulation must be interpreted to tax capital transactions.

Section 22(a) (p. 2, *supra*) will not be interpreted toward an invalid result as unconstitutional under the Sixteenth Amendment. *Panama R. R. Co.* v. *Johnson,* 264 U. S. 375, 390 (1924).

In *Manhattan General Equipment Company* v. *Commissioner,* 297 U. S. 129, 134 (1936), this Court said:

> "A regulation which * * * operates to create a rule out of harmony with the statute, is a mere nullity. * * * And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable."

Section 22(a) taxes income. Income is supposed to have a plain and understandable meaning and not a metaphysical one such as satisfies the Court below. See *Irwin* v. *Gavit,* 268 U. S. 161, 166 (1925); *United States* v. *Kirby Lumber Co.,* 284 U. S. 1 (1931); *Eisner* v. *Macomber,* 252 U. S. 189, 206 (1920).

We have shown above (pp. 11-14) the capital nature of this transaction. Regulation or none, the transaction may not be taxed under Section 22(a).

POINT IV

If the statute does support the regulation, then, to the extent it covers the capital transactions here, it is invalid because not authorized by the Sixteenth Amendment.

Because of our argument above (pp. 11-14) based upon the fact that the transactions taxed involved the raising

of capital, we shall only say that if Section 22(a) covers this situation then the Sixteenth Amendment has been breached. The Amendment taxes income, and says:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

CONCLUSION

For the reasons stated in the petition and in this brief the application for a writ of certiorari should be granted.

Respectfully submitted,

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